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INTERNAL REVENUE SERVICE
TE/GE TECHNICAL ADVICE MEMORANDUM 200218038

APR 23 2001

Area Manager -

T:EO:B2

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's ID Number:

Date of Conference:

LEGEND: L =
M =
N =
O =
x =
y =

ISSUES:

1. Whether L is liable for Chapter 42 excise taxes under section 4944(a) of the Internal Revenue Code.

2. If L is liable for the excise taxes imposed by section 4944(a)(l) of the Code, whether the taxes should be abated under section 4962(a).

FACTS:

L is exempt from federal income tax under section 501(c)(3) of the Code and is a private foundation within the meaning of section 509(a).

M, is exempt from federal income tax under section 50l(c)(3) and is a public charity. M's charitable program is to provide entrepreneurship training and mentoring to at-risk youths. N was established by M to create an endowment fund for M. N has been recognized as exempt under section 50l(c)(3) of the Code and is a 509(a)(3) supporting organization to M. N is the general partner of O, a limited partnership, which was established to provide funding to M.

L invested approximately x% of its assets in O. The assets in O were traded in the futures and forward markets. O was managed without charge by a well-regarded registered commodity trading advisor. O's assets were allocated among four well known commodity trading advisors, each of whom had different trading styles. O's manager closely reviewed the performance of O through daily reports tracking the net asset values of O's assets. L was actively involved in the planning phases of N and O, including choosing the manager and trading advisors. O was to operate for a limited number of years, at the end of which L was entitled to

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receive all the assets in its account. Predominantly all of O's income was allocated to N. L had also negotiated with O for the right to cause the partnership to redeem all or part of L's investment for cash at any time upon written notice. Neither M, N, or O, nor any of the parties involved in establishing or operating O are disqualified persons within the meaning of sections 4946 and 4941 of the Code as to L.

L requested a ruling from the Service in y concerning, among other issues not pertinent to this memorandum, whether the investment in the partnership was a program related investment (PRI), as that term is described in section 4944(c) of the Code and the applicable regulations. Materials submitted with the ruling request included a letter from legal counsel for M which concluded that the investment by L should be considered a PRI and hence it could not be a jeopardizing investment. A separate legal opinion with the same conclusion was also obtained by N from an independent attorney with vast experience in exempt organizations. The ruling from the Service was requested after the investment had been made (but in a concurrent tax year) and the funds remained invested in the partnership over the time frame the ruling request was being considered by the Service.

After a series of conferences, the Service advised L that it was leaning adversely on the PRI issue. L withdrew the ruling request and subsequently exercised its right to cause the partnership to redeem the Foundation's limited partnership interest.

The examining agent has concluded that L entered into the partnership to provide an investment vehicle that was not a PRI. The agent viewed the expected return by L on its investment minimal when compared to the risks involved. He also noted that other more reasonable investment vehicles were available and L could have gotten a better return on its money with far less risk. Furthermore, the investment put at risk approximately x% of L's assets. Based on this analysis, the agent concluded that a jeopardizing investment was present and the section 4944 tax was due. However, he also recommended that any tax assessed should be abated because legal advice in this matter was provided to L coincident with the investment.

LAW:

Section 501(c)(3) of the Code provides, in part, for exemption from federal income tax for a corporation organized and operated exclusively for charitable, scientific or educational purposes provided no part of the corporation's net earnings inure to the benefit of any private shareholder or individual.

Section 509(a) of the Code provides that, unless specifically excepted, a domestic or foreign organization described in section 501(c)(3) is a private foundation and subject to the excise taxes of Chapter 42.

Section 4941(a) of the Code imposes excise tax on acts of self-dealing between a private foundation and any of its disqualified persons as defined in section 4946 of the Code.

Section 4941(d)(I)(E) of the Code provides that the term self-dealing means any direct or indirect transfer to, or use by or for the benefit of a disqualified person of the income or assets of a private foundation.

Section 4944(a) of the Code provides for the imposition of an excise tax on investments which jeopardize the carrying out of any of the exempt purposes of a private foundation.

Re:

Section 53.4944-1(a)(2)(i) of the Foundation and Similar Excise Tax Regulations states that with certain exceptions an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination as to whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944. However, certain types of investments, such as an investment in futures, require close scrutiny to determine whether foundation managers have met the requisite standard of ordinary business care and prudence.

Section 4944(c) provides that certain investments, referred to as program-related investments are excluded from the definition of jeopardy investments. The program related investments are defined as investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property.

Section 53.4944-3(a)(1) of the regulations discusses program-related investments. In general, such an investment must possess the following characteristics:

(i) the primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B) of the Code;
(ii) no significant purpose of the investment is the production of income or the appreciation of property; and
(iii) no purpose of the investment is to accomplish the purpose of attempting to influence legislation or to attempt to participate in, or intervene in, any political campaign on behalf of any candidate for public office.

Section 53-4944-3(a)(2)(i) of the regulations provides that an investment shall be considered as made primarily to accomplish a purpose described in section I70(c)(2)(B), if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities. . For purposes of section 4944 and Sections. 53.4944-1 through 53.4944-6, the term 'purposes described in section 170(c)(2)(B)' shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c).

Section 53.4944-3(a)(2)(iii) of the regulations provides that in determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

Re:

Section 53.4944-3(b) provides various examples of program related investments:

Example (3) describes a small business enterprise, X, located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example (5). describes a business enterprise, X, which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example (7) describes a private foundation (X) which invests $100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.

Section 4946(a)(l)(A) of the Code defines the term disqualified person as including a foundation manager of the foundation and a substantial contributor to the foundation.

Section 4946a)(l)(E) of the Code provides that the term disqualified person includes a corporation in which disqualified persons own more than 35 percent of the total combined voting power.

Section 4962 grants the Service discretionary authority to abate certain Chapter 42 first tier taxes including taxes under section 4944(a) in the case of jeopardizing investments. In order to qualify for such an abatement, the Foundation must remove the investment from jeopardy within the correction period. The correction period begins with the date on which the jeopardizing investment was made and ends 90 days after the mailing of a notice of deficiency. The authority to abate substantial first-tier taxes was delegated to the Assistant Commissioner (EP/EO) (now Director, Exempt Organizations Division). The term substantial is described as a sum exceeding $200,000. See Delegation Order No. 237, February 12, 1992.

RATIONALE:

Section 4944(a) of the Code imposes an excise tax upon a private foundation which invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes. An investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such an

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Re:

investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment. The regulations specifically recognize that no category of investments shall be treated as a per se violation of section 4944. However, certain investments are to be closely scrutinized. Investments which demand close scrutiny are investments in commodities and futures. PRIs, as defined in section 4944(c), regardless of the risk or the potential return, are excepted from the definition of jeopardizing investments.

A PRI is defined as an investment, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property. Here the limited partnership was established to invest in commodities and futures. Unlike the PRI's described in examples (3) and (5) of section 53.4944-3(b) of the regulations, supra, L's investments in the futures and commodities markets were solely a way to produce investment returns to be used by L in accomplishing its exempt purposes. This situation is precisely on point with example (7) where there was no relationship between the investment per se and the accomplishment of exempt purposes except for producing a return. If L had directly loaned N funds to be used, invested, and controlled by N to create an N endowment, L would have made a PRI. Accordingly, we have concluded that L's investment in O was not a PRI.

Even though we have determined that the investment L made in O was not a PRI, the issue remains whether L's investment in O is a jeopardizing investment within the meaning of section 4944 of the Code.

As pointed out by the examining agent, L invested a significant amount of its assets in O and may have received a better return with less risk in another investment vehicle. However, neither of these elements are necessarily dispositive of the issue of whether a jeopardizing investment was present. Consideration must be given at the time the investment is made and merely because the end result is not as beneficial to the financial interests of a private foundation as another investment might have been is not grounds in itself for finding that a jeopardizing investment was made. Nor should the percent of assets invested in one investment area be a sole consideration. Diversification is recognized in section 53.4944-1(a)(2)(i) as being one factor to be considered in determining whether a jeopardizing investment is present. The determination as to whether something is a jeopardizing investment should be made on an investment by investment inquiry based on the prevailing facts and circumstances taking into account the foundation's portfolio as a whole. The key element is whether the foundation managers exercised ordinary business care and prudence.

The information submitted shows that O was established to trade in futures and commodities, a close scrutiny type of investment. L and its managers were actively involved in establishing O, including choosing the manager and investment advisors. Four different advisor allocations were used to counterbalance the investments. L negotiated special conditions on the investment which gave it the right to withdraw its funds at anytime upon written notice prior to the end of the normal term of the partnership. Further, L had reviewed two separate opinions of counsel which both concluded that investing in O was not a jeopardizing investment. Finally, L has stated that that neither its mangers nor its disqualified persons had any business of other relations with O that would have been furthered by L making this investment. Neither O, its manager, nor any of its financial advisors were disqualified persons as to L. The examination of L did not find evidence of any section 4941 self dealing or section 501(c)(3) private benefit issues.

Under the facts and circumstances presented, we have concluded that L and its managers took reasonable measures and exercised ordinary business care and prudence prior to entering the O investment. Accordingly, we have concluded that the investment in O was not a jeopardizing investment within the meaning of section 4944 and the applicable regulations.

Re:

Inasmuch as we have concluded that the investment by L in O was not a jeopardizing investment, there is no reason to give consideration to the abatement issue.

CONCLUSION:

1. L is not liable for Chapter 42 excise taxes under section 4944(a) of the Code.

2. Because L is not liable for the excise taxes imposed by section 4944(a) of the Code, there is no reason to consider whether the taxes be abated under section 4962(a).

END